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Beauty is In the Eye of the Beholder

When a seller and a buyer differ about the value of the seller's company, earnout structures may be used to bridge that value gap.

by Mark D. Working and Michael T. Newsome

A seller has an advantage over a buyer, in terms of knowledge about the business and its prospects, potential, and risks. Sellers tend to be flush with confidence and expect that future results are already "in the bag." Naturally, buyers are skeptical about early-stage business initiatives and leery of underestimating potential risks. The value of a business is the present value of its *expected* future cash flows. Therefore, the disparity between seller and buyer expectations regarding future prospects is often at the root of any value gap in sale negotiations.

When conflicting expectations emerge, the parties have two choices. Wait, as the future unfolds one way or another, or craft a structure, known as an earnout, that allows for the possibility of additional compensation, if the seller's expectations of future performance are realized. Earnout structures are commonly used to span a value gap and complete transactions, but they do not assure that either party, or both, will get what they bargained for.

WHAT IS AN EARNOUT?

In essence, an earnout represents a contingent component of the total purchase price, together with a set of rules or a formula against which future performance will be measured, in order to determine if, and how much, additional compensation will be owed. The seller believes that the earnout will result in a greater sale price when the future is known. The buyer takes comfort in knowing that, if the seller's rosy view is not realized, he has not overpaid. Conversely, if the seller's expectations are achieved, then a higher value for the business is justified.

STRUCTURAL CHALLENGES

As appealing as an earnout can be conceptually, in practice, the devil is in the details. The challenges inherent to crafting an earnout begin with isolating the specific differences in future expectations between the two parties and applying the most appropriate economic metrics for measuring those disparities.

Sellers are interested in making sure that the new owners make every effort to achieve the earnout as quickly as possible, and have the wherewithal to make any payments. So, issues of liquidity and collateral are usually part of the negotiation. A sophisticated seller is also concerned about the integrity of the earnout measurement system, to protect against buyer efforts to manipulate the numbers to minimize or avoid payment. On the other side, the buyer really doesn't want to make future payments, and is concerned that the earnout may negatively impact business strategy and/or financial flexibility. In the end, all differences relate to future performance (cash flow), but grow out of specific cost or revenue issues:

- Operational improvement initiatives are expected to result in lower costs, but are not yet evident.
- A key customer relationship is perceived to be either in jeopardy, or not yet fully developed, and business performance may vary depending on how the relationship progresses.
- A new product/service has been introduced, but success remains unproven.

As appealing as an earnout can be conceptually, in practice, the devil is in the details. The challenges inherent to crafting an earnout begin with isolating the specific differences in future expectations between the two parties and the best metrics for measuring those disparities in economic terms.

Specific Cost or Revenue Issues Related to Future Performance

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A new product / service has been introduced, but success remains unproven.

As an example of the challenges, we are aware of a situation in which a key salesperson unexpectedly left a firm shortly before a sale transaction was scheduled to close. This put several important customer relationships in jeopardy. As a consequence, the deal was renegotiated and a meaningful portion of the price was allocated to an earnout. At the outset, the negotiations focused on compensation for the sales and gross margins specific to the at-risk accounts. In order to get a deal done, it proved necessary to work out a simpler arrangement that called for additional payments if total revenues exceeded an agreed threshold over a three-year period. The negotiation of the fine points of the earnout spanned several weeks and numerous drafts, as the seller tried to assure that the buyer could not circumvent the spirit of the agreement, while the buyer fought to make sure that its flexibility to manage the business was not impaired. In the end, both parties were worn out and frustrated—ostensibly, the hallmark of a "fair" deal. The earnout was by far the most difficult aspect of the deal.

THE LAW OF UNINTENDED CONSEQUENCES

Earnouts are risky for both parties for a host of reasons, not the least of which is that

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a business is an organic entity operating in a dynamic, ever-changing environment. All of the factors and forces that will bear on a business in the future cannot be anticipated. Earnouts work best when based on a simple set

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of variables, where the interactions among those variables are static. Unfortunately, the business environment isn't static, and no formula can anticipate all possible outcomes. Often, well-intentioned earnout formulas end up being frighteningly complex, and invariably create unanticipated and abnormal economic incentives in the business.

In the aforementioned example, unintended consequences surfaced after the deal closed. The business struggled a bit during the economic downturn, as sales dropped off and margins tightened. For the first year, no earnout payment was required. Then, a revamped sales and marketing effort began to generate real success as the economy rebounded. Unfortunately, in a highly competitive market, margins never returned to the historical norm. The company now faces the quandary of robust demand for its products and the need to respond with additional capital investment. At the same time, the return from incremental sales (after earnout payments) does not justify further investment. The company is in the unenviable dilemma of either choosing to step on the brakes with regard to growth, in spite of surging momentum, or eroding long-term shareholder returns with additional purchase price obligations. On the other hand, the seller is faced with a potential loss of value due to the incentives to limit growth and some concern about the ability to pay any future obligations that are created.

CONCLUSION

Either party, or both, to an earnout may end up disappointed with the final outcome, which can spark fingerpointing and even litigation. Yet, so long as both parties recognize the risks inherent in predicting the future, a well-conceived earnout can allow a deal to occur that would not happen otherwise. The keys to a workable earnout and avoiding

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lasting brain damage are to keep it simple, short and measurable. In the final analysis, an earnout may be the best (albeit imperfect) way to match the risk/return attributes of both the seller and buyer. Bottomline, if a seller gets a little more or less than expected and a buyer pays slightly more or less than his value target, then the earnout mechanism did a reasonable job. No greater precision can be expected. ❖

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Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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